

## USAID FORUM SERIES PROBLEM STATEMENT

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I think we can agree that development assistance targeted at economic development and growth has not been very successful. Easterly's book on The Elusive Quest for Growth lays out quite clearly the historical failure of donor programs. We are in a situation somewhat comparable to the situation of the U.S. military in Vietnam. Just as their "victories in battle" were progressively limited to areas closer and closer to Saigon, so too are our "program successes" in promoting development occurring in ever declining budgets, even though the enormity of the challenge is not going away. Congress has lost confidence in USAID and its capability to promote growth. We will not restore confidence by shifting bodies and renaming offices. We have to do things differently. That is the objective of the forum exercise--to create awareness within USAID that institutions are important to our work and to incorporate institutional analysis in our analytical, design, and implementation work.

If you read the literature today on development or if you had attended the recent American Economic Association conference in Washington, institutional reform is taking over in discussions of growth and development. Getting institutions right is the new development paradigm. However it can be confusing. We read about institutional infrastructure, institutional framework, institutional environment, institutional arrangements, institutional ecology, and institutions of governance, to name a few. We also have old institutional economics, new institutional economics, and evolutionary institutional economics. What does it all mean? That is what I hope we can find out by inviting the academic and research community to meet with us and discuss how we might introduce into our development programs what they are learning about the role of institutions in promoting economic growth. We are the practitioners; they are the thinkers and researchers. I believe we can learn from each other.

The goal of the exercise is to improve USAID's delivery of foreign assistance for promoting economic growth and development.

### **How do we design activities now?**

When we design a project for a country, we typically send a request to CDIE and ask them to send us evaluations of what USAID missions have done in other countries in terms of addressing similar problems. We search for best practices in other countries. However, those best practices are based on the institutional environment and institutional arrangements in those particular countries. What the academic community and researchers tell us is that institutions are context specific. They are the result of historical and political developments in that country. Trying to import institutions from another country is not going to work. As Douglas North has written, "...the common imposition of a set of rules will lead to widely divergent outcomes in societies with different institutional arrangements."

A second common problem when we begin our design work is to focus on a problem in a particular sector without really examining interrelationships with other sectors, particularly those relating to institutions. For example, smallholder farmers in many developing countries were receiving inadequate prices for their output because government -marketing boards were inefficient and subject to rent seeking and corruption. The advice was to eliminate the marketing boards and allow the market to work. The result was that smallholder farmers today generally do receive a higher proportion of world market prices for their output. However, they use fewer inputs, such as fertilizer and insecticides, and, in consequence, productivity and product quality have deteriorated. In eliminating the marketing boards, we also eliminated sources of finance and sources of inputs for farmers.

We need to take a more comprehensive look at the problems we deal with. Reforming an organization without, at the same time, considering provision of complementary organizations and institutions is likely to lead to failure. "Best practices" are not best practices unless we understand and include complementary institutions needed for any particular institution to work.

A third problem related to the first and second is that we pretty much ignore cultural factors when we propose solutions. We have a one size fits all strategy. However, culture affects the way a society accepts changes. A market system is based on a culture of self-interest and individual responsibility and that can be alien in those countries that prize collectivism and egalitarianism. We need guidance on how cultural issues impact our work.

A fourth problem, I believe is the introduction of institutional reforms that are not recognized as solving real problems in the countries we work in. Our technical assistance rewrites laws, reforms judiciaries, and introduces procedural changes in the way regulatory and licensing agencies operate, but unless those changes are recognized as ones that solve real problems, the institutions we have introduced will not be viewed as legitimate.<sup>1</sup> When I sit in on program reviews, I generally hear complaints that recently enacted laws and reforms that USAID helped introduce in a country are not in fact being implemented. Rather than accept responsibility for designing a reform that was not recognized as needed, we instead blame the host country government for not having political will or commitment.

A fifth problem is that we have no realistic assessment of what we can accomplish. For example, a USAID country strategy was recently approved for a transition state. According to the Heritage Foundation's Index of Economic Freedom, the country is classified as "mostly unfree," meaning it has a long way to go. Nevertheless, the mission states in its strategy document that at the end of five years the following will be achieved, "...a fully democratic society and productive market economy that together serve as a cornerstone for prosperity and stability in the region. There are four preconditions ...to achieve this goal, each of which corresponds to one of the mission's Strategic Objectives. The first is the development of conditions that foster competition and constantly increasing productivity, innovation and job creation in a vigorous private-sector led economy. The second, no less important, is the building of a transparent, accountable and effective political system at central, regional and local levels that is responsive to citizen needs and fundamental principles of democracy and human rights." The document lists the other two strategic objectives, which are not relevant for this discussion. The document then states, "Each Strategic Objective is believed to be achievable within the planning period considering the projected resources available and USAID's capacity to attain necessary results."

We need help to understand what is a realistic time frame for achieving institutional reforms. Can targets be developed in terms of how long it will take to raise an Economic Freedom score, say by 0.5 points? Our results reporting system leads us to use unrealistic time frames and silly or restrictive indicators.

A final problem is the possible incompatibility between institutions introduced by one donor and institutions introduced by others. European donors tend to design their private sector activities to reflect institutions in their own countries. This might entail the mandatory membership in private sector associations with the payment of dues, whether private firms want to join or not. Employer associations are quite prevalent in several European countries, with associated industry wide bargaining with labor. We don't have that in the U.S. Our technical assistance is more aimed at creating institutions that promote competition in product, labor and input markets. U.S. product and labor markets are much more competitive than analogous European institutions. If donors try to shape institutions to reflect their economies, is it possible that the resulting institutional structure in a developing country has instances of incompatibility? If there are such instances, we

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<sup>1</sup> See Marina Ottaway, "Rebuilding State Institutions in Collapsed States," Development and Change 1001-1023 (2002) for a discussion of de facto and legitimate institutions from the perspective of rebuilding failed states.

need to know how to address them. There is a growing literature on comparative institutional advantages. We need to benefit from such analyses.

### **What can the academic and research community do for us?**

1. We need an analytical framework that will guide us in how to carry out a diagnostic so we can identify the root causes of institutional failure. How do we assess whether we have (1) a principal agent problem resulting from the misalignment of incentives, (2) an insecure property rights problem or (3) a problem resulting from missing complementary institutions? Can the academic and research community construct for us the equivalent of an input/output table centered on the interrelationships between institutions?

2. If we have correctly identified the root causes of a problem, how do we identify solutions to address the root causes? We need a framework for analysis that will help us assess the compatibility between the design of proposed project activities and the existing institutional environment and arrangements. Is there a fit? If not, are there known, relatively limited changes to the institutional environment or, better yet, specific institutional arrangements that have a high probability of improving the fit?

Normally we are concerned with reducing transaction costs so more cooperative exchanges can take place. However, in many of the countries we work in, corruption and rent seeking are common problems. How do we increase the transaction costs of rent seeking and corruption? Punishment or the increased probability of punishment is one way, but what else should be included in our designs?

Everyone recognizes the importance of the rule of law for freedom and for capital accumulation and growth. However, the current USAID practice is to emphasize the role of the rule of law in human rights, criminal process and elections, but not its role in supporting markets and economic growth. In general when the rule of law is discussed in the development literature, it is discussed from the macro perspective, at the constitutional and judicial level. We must seek to embed the rule of law in each and every institution we attempt to reform. Entrepreneurs must be treated equally before government agencies. How can we design our solutions to do that?

3. If we have correctly identified the root causes of institutional failure and we have correctly identified solutions, how do we ensure implementation of the solutions? What should be the role of government? Markets require property rights and a legal system, and both involve the state. However, involvement of the state carries its own inefficiencies, including rent seeking, corruption, and coercion in the name of the "common good".

We know that institutions are important for economic performance and we generally know which institutions are needed most. But as Douglas North has stated, we don't know how to get there. Consequently, can we learn how to get there or are institutional reforms so context specific, so historically and politically dependent, that as outsiders we will never be able to play a constructive role? If that is true, we need to know that now; so we don't waste resources in futile efforts to directly promote institutional change.

One alternative is to follow Ludwig Lachmann's recommendation, which he made when he proposed Economic Budgeting as a substitute for economic planning.<sup>2</sup> He wrote, "...we find here a method, not of engineering growth by decree, but of *cultivating* it by creating the conditions, at least so far as entrepreneurial knowledge goes, which may give rise to it. The analogy of the gardener, as distinct from the engineer, naturally suggests itself." If that is all we can realistically achieve, then we need guidance from the academic and research community on how to do that.

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<sup>2</sup> See Ludwig, Lachmann, *Cultivated Growth and the Market Economy*, South African Journal of Economics, pp. 163-174, 1963.

Another possible alternative is to develop the capacity of a country's own academic and research community to engage in their own diagnostics of problems and solutions. This is a recommendation made by Mary Shirley at our second forum. I will quote from her comments.

"...at the Ronald Coase Institute we have a different approach. We believe that the obstacles to development are largely institutional in nature. More and more development agencies have recently discovered the importance of institutions. But unlike them, we don't believe that outsiders can engineer institutional change through a combination of money and advice, much like you would build a dam to change the flow of a river. Our model is to build the capacity of local scholars to understand their own country's institutions and devise realistic solutions to bring down transaction costs, solutions that will work in their own institutional setting, and to help them communicate their findings to policy makers and teach it to future opinion leaders. Our goal is to help countries develop the intellectual capital they need to seize political opportunities, change their institutions, and create opportunities for people to improve their lives."

Unfortunately, USAID has pretty much withdrawn funding for graduate training and scholarship.

Should our role be an indirect one rather than a direct one? Should we support capacity building of institutions of higher learning and think tanks in developing countries focused on economic policy and institutional reforms? Should we create a collaborative framework so that U.S. expertise in new institutional economics, public choice, and constitutional political economy can be drawn on to support local researchers in performing their diagnostic work and in formulating proposed solutions?

When we formed this partnership with IRIS to organize these forums our intent was very modest. It was to bring USAID up to date with what is known about the role of institutions in promoting economic growth and more importantly, to identify practical applications of NIE concepts and findings. The tools that IRIS will deliver to USAID are examples of practical applications. The tools by themselves will not solve our challenges in promoting growth but they will help improve what we do and will establish procedures by which we can better learn from what we do so that our new programs can be designed more effectively. From the beginning, this has been a research and development activity. I would like to thank Chas Cadwell for agreeing to take on this assignment and Clifford Zinnes and his team for the fruitful recommendations they have delivered. I look forward to the contributions that Peter Boettke and his Mercatus Center team will deliver to us in the future.